

STATE OF WASHINGTON
STATE INVESTMENT BOARD

Private Markets Committee Meeting
Minutes

November 6, 2003

The Private Markets Committee met in open public session at 9:04 A.M. in the boardroom at the Washington State Investment Board in Olympia, Washington.

Members Present: Debbie Brookman, Chair
 John Charles
 Mike Colleran
 Jeffrey Hanna
 Patrick McElligott
 Jeff Seely

Members Absent: John Magnuson
 Senator Zarelli

Other Board Members
Present: Charles Kaminski

Others Present: Joe Dear, Executive Director
 Gary Bruebaker, Chief Investment Officer
 Tom Ruggels, Senior Investment Officer – Private Equity
 Sam Green, Investment Officer – Private Equity
 Janet Kruzel, Investment Officer – Private Equity
 Linda Buchanan, Administrative Secretary

 Paul Silver, Senior Assistant Attorney General
 Eric Becker, Pacific Corporate Group
 Bill Macaulay, First Reserve
 Hardy Murchison, First Reserve
 John E. von Schlegell, Endeavour Capital
 Stephen E. Babson, Endeavour Capital
 Aaron S. Richmond, Endeavour Capital

[Names of other individuals attending the meeting are not included in the minutes, but are listed in the permanent record.]

The meeting convened at 9:04 A.M. with Chair Brookman identifying members present.

REVIEW AND APPROVAL OF MINUTES – OCTOBER 2, 2003

Mr. Charles moved to adopt the October 2, 2003, minutes. Mr. McElligott seconded, and the motion carried unanimously.

PRIVATE EQUITY – FIRST RESERVE FUND X, L.P. – INVESTMENT RECOMMENDATION

Mr. Becker, Pacific Corporate Group (PCG), and Mr. Green, Investment Officer – Private Equity, introduced themselves. Mr. Green stated that staff is recommending a \$200 million investment in First Reserve Fund X, L.P., and that PCG concurs with the recommendation. Mr. Green explained that the WSIB has invested in two prior First Reserve funds. He stated that staff knows the firm well from continuous monitoring and serving on the advisory board. Mr. Green stated that this fund was not in the revised investment plan for 2003 presented to the committee. As the fund will not close until 2004, staff considers the investment as part of the 2004 annual plan. Mr. Green described the firm's strategy, team, experience in the energy sector, diversification across the energy sectors and supply chain, and realizations. He stated that the investment is an attractive fit in the WSIB portfolio. Mr. Green discussed concerns with the sector focus mitigated by the diversification within the sector, and a key-man risk mitigated by provisions in the legal documents.

Mr. Becker stated that PCG has a long history with First Reserve and that the firm has generated strong and consistent returns. He explained that PCG believes the outlook for First Reserve is positive due to favorable economics and fundamentals in the industry. Mr. Becker discussed the firm's long-standing presence, competitive advantage, experience, well-balanced financial and operating expertise, deal flow, and ability to add value to portfolio companies. He stated that the investment has a strong alignment of interest due to a low management fee, a high sharing ratio of additive fees, and a meaningful general partner commitment. Mr. Becker stated that PCG concurs with staff's recommendation of a \$200 million commitment to First Reserve Fund X, L.P.

Discussion ensued regarding investment size in Fund IX, consensus of staff and PCG on investment recommendations, planning process for the WSIB portfolio investments, and First Reserve valuations.

Mr. Macaulay and Mr. Murchison, First Reserve, introduced themselves.

Mr. Macaulay described the firm's focus on the energy sector, strategy, experience, history, diversification, and performance record. He discussed opportunities for Fund X, market trends, current limited partners, team, and location.

Mr. Murchison described segments within the energy sector, domestic and international exposure, growing requirements for infrastructure in emerging markets, and investment strategies. He stated that many infrastructure segments are largely unconsolidated.

Discussion ensued regarding potential markets, processes, sources, global trends, investments in Washington, and the potential impact of government regulations.

The Committee discussed the value of an investment in the energy sector, diversification of the fund, performance record, consistent returns, and differences between PCG and First Reserve's valuations.

Mr. Colleran moved that the decision on this investment be postponed until the due diligence on this investment is improved to include the audit history or lack thereof of Dresser Industries that is not addressed.

Mr. Colleran supported his motion by stating that the staff's due diligence failed to disclose to the Committee information regarding Dresser, Inc. bond default caused by the absence of audited financial statements and did not analyze the Alman Z Score for Quanta Services. Mr. Colleran stated that the issue does not necessarily deal with the specific investment, but with the quality and amount of information provided to the Board.

Mr. Dear stated that staff stands behind the work, is strong in the conviction that this investment is appropriate for the Board at the level recommended, and the material presented to the Committee is adequate for the Committee to make a recommendation to the full Board for action on November 20. He stated that staff would do its utmost between now and then to resolve any questions Mr. Colleran might have about Dresser or anything else in this investment.

Mr. Green stated that the audit issue resulted from the purchase of Dresser. In doing due diligence, it was discovered that the pension liability was overstated by the incumbent auditors, Arthur Andersen. He explained that Arthur Andersen ran into trouble at the time and was prohibited from doing attestation services. As a result, they could not come in and restate their financial statements for this fairly immaterial and conservative misstatement. Therefore, Dresser had to hire a new audit firm which could not rely on any of Arthur Andersen's numbers. The new audit firm had to repeat three years of audit work. This resulted in several million dollars of additional audit fees. The issue was brought before the advisory board.

Mr. Becker stated that PCG became comfortable with the event by researching how the public market reacted. The bonds were trading at a premium.

Mr. McElligott asked if PCG was aware of the audit problem.

Mr. Becker replied affirmatively.

Mr. McElligott asked if PCG was aware that Quanta had an F score and whether they used that as information for the Board.

Mr. Becker replied that they did not but would be happy to do so and report to the Board.

Mr. McElligott asked if it would make a difference on the investment.

Mr. Becker replied that the public market pricing and any credit deficiency, if that is the case, based on the public markets valuation of the company, is substantially above the general partners' cost. He stated that PCG took a conservative approach and discounted the publicly traded stock price by 20 percent, is comfortable with it, and stands by that valuation.

Mr. McElligott asked Mr. Colleran whether the information would have changed the Committee's decision to make a recommendation to the Board. Mr. McElligott stated that if the information had been brought forward and the recommendation was still to bring the investment to the Board, he would have been comfortable with the recommendation. He asked if Mr. Green was aware of it and still felt it was a worthwhile investment.

Mr. Green replied affirmatively. He stated that the extent of the problems is immaterial.

Mr. Hanna stated that the fact staff was aware of the issue with Dresser and still recommended the investment is an important point of information. He stated that it would be common for companies in the leveraged buyout portfolio to have low Z Scores since the nature of a leveraged buyout is to take a company and leverage it up to improve and sell it. Mr. Hanna asked whether Mr. Becker, Mr. Colleran, or Mr. Green believe that the Z Score is something of great significance when looking at the WSIB leveraged buyout portfolios.

Mr. Becker stated that he would need to research the information to make the analysis of its relevancy and application in private equity.

Mr. Colleran stated that his concern was the difference in valuation between First Reserve and PCG. He suggested that sometimes the stock price does not recognize what a debt officer would recognize in terms of the willingness to loan money. Mr. Colleran stated that his original point was that Dresser is in default on the bonds and the default would not be cured until audited financial statements are produced. He stated that his motion is on the floor to delay a decision on this investment until at least the results of the re-audit or the information based on the questions are given.

The motion was lost due to a lack of a second.

Mr. Charles moved that the Private Markets Committee recommend to the Board an investment of up to \$200 million, plus fees and expenses, in First Reserve Fund X, L.P., subject to acceptable presentation to the Board at the Board meeting of an explanation of the pending Dresser audit engagement, the valuation of Quanta Services including an explanation of the large variances between the information provided by First Reserve and by staff and PCG reported. Mr. McElligott seconded, and the motion carried with Mr. Colleran voting no.

[A recess was called at 10:18 A.M. and the regular session reconvened at 10:27 A.M.]

PRIVATE EQUITY – ENDEAVOUR CAPITAL FUND IV, L.P. – INVESTMENT RECOMMENDATION

Ms. Kruzel, Investment Officer – Private Equity, stated that staff is recommending an investment of \$50 million in Endeavour Capital Fund IV, L.P., a middle-market private equity fund, and that PCG also recommends a \$50 million investment. She explained that the fund has a Northwest focus with extensive network relationships. Ms. Kruzel stated that this would represent a new general partner relationship as presented in the revised annual plan. She explained that this segment is underrepresented in the WSIB portfolio at this time. Ms. Kruzel described the firm's team, reputation, experience, growth, performance, portfolio companies, strategy, approach, competition, and long-term vision. She discussed the fund's fit in the WSIB's portfolio. Ms. Kruzel explained that two concerns were regional focus, mitigated by broadly defined region and diversification, and a key-man issue mitigated by provisions in legal documents and compensated by actions to develop team strength.

Mr. Becker stated that PCG has a long-standing relationship with firm. He discussed the fund's fit in the WSIB portfolio. Mr. Becker explained that the fund is not expected to compete or invest with other funds in the WSIB portfolio. He discussed the firm's performance, ability to generate value, and

recent geographic expansion. He stated that PCG recommends a \$50 million commitment to Endeavour Capital IV, L.P.

Discussion ensued regarding recent realizations, geographic region, performance data reporting, gross and net IRR, and exit strategies.

Mr. von Schlegell, Mr. Babson, and Mr. Richmond, Endeavour Capital, introduced themselves.

Mr. von Schlegell discussed the firm's history, growth, investment focus, reputation, philosophy, performance, returns, strategy, geographic focus, guiding principles, and long-term view of relationships.

Mr. Babson described the firm's target investment profile, target company profile, and target management profile. He discussed long-term value creation, focus, consistency of returns, target investment companies, and strategy. He stated that the firm does not invest in start-up companies, real estate, energy, or companies subject to technology risk or turnarounds. Mr. Babson discussed exit opportunities.

Mr. Richmond described investment considerations. He discussed existing relationships, reputation, proactive research, regional focus, due diligence process, and involvement with portfolio companies.

Mr. von Schlegell described the firm's principals. He discussed Fund IV planning, investor base, fund mechanics, and franchise.

Mr. Babson discussed investment processes, due diligence, deal flow, and regional diversification.

Discussion ensued regarding competition, investment history, the need to be flexible and opportunistic, leverage, fund size, and exit strategies.

The Committee discussed the WSIB investment plan, fit in the WSIB portfolio, economically targeted investing, and key-man provisions.

Mr. Charles moved that the Private Markets Committee recommend to the Board an investment of up to \$50 million, plus fees and expenses, in Endeavour Capital Fund IV, L.P., subject to final negotiation of terms and conditions. Mr. McElligott seconded, the motion carried unanimously.

PRIVATE MARKETS CLOSING LOG

The Private Markets Closing Log was presented for informational purposes.

Discussion ensued regarding the closing of TPG and the size of the WSIB investment.

OTHER ITEMS

There being no further business to come before the Committee, the meeting adjourned at 11:33 A.M.